LOSS OF ECONOMIC MOMENTUM LEADS TO SLOWDOWN IN SIOR MARKETS

BY LAWRENCE YUN, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST & GEORGE RATIU, NAR DIRECTOR, QUANTITATIVE & COMMERCIAL RESEARCH, NATIONAL ASSOCIATION OF REALTORS®

Based on a recent survey of SIOR members, the SIOR Commercial Real Estate Index for the first quarter of 2015 was essentially flat, achieving a minimal 0.5 point gain. The national index is based on 10 key variables measuring pertinent to the performance of U.S. industrial and office markets. On a positive note, it was the fourth consecutive quarter above 100, the threshold indicating improving market conditions.

Office and industrial markets reflected the pause in economic momentum in the first quarter of the year. The SIOR Commercial Real Estate Index has two components, whose trends largely offset each other. First, the SIOR office markets stumbled, with the office index declining 4.2 points. Employers' continued their emphasis on increasing space-utilization efficiencies, resulting in an elevated availability of space. Second, the industrial index accelerated during the quarter, gaining 3.7 points to a value of 123.7. Demand for industrial space has been up—as a result of international trade and on-line shopping which diverts space from retail to warehouses. As retail purchases have increased on-line, warehouse distribution centers have gained prominence. The industrial index has been over the 100-point value for the past six quarters, indicating strong demand for space.

Most importantly, SIOR members reported that, on balance, fundamentals continued improving:

• Leasing activity advanced, with 58 percent of SIORs finding it above historical levels.

• Rent growth moved sideways for office and industrial properties—97 percent ascertained that rents were in line with or above long-term averages; only 3 percent of SIORs considered that asking rents were below those of one year ago.

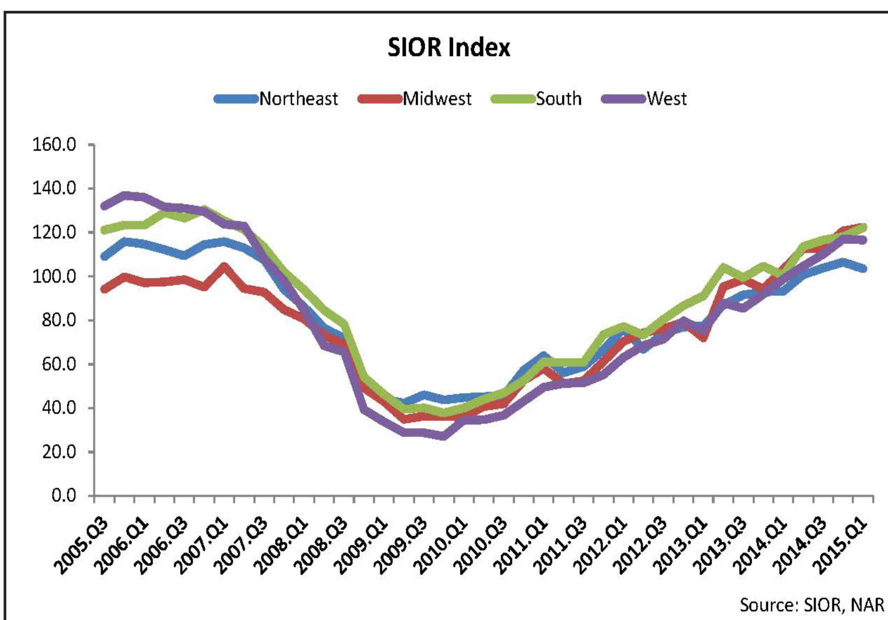
• Vacancies remained steady, with 77 percent reporting lower availability rates.

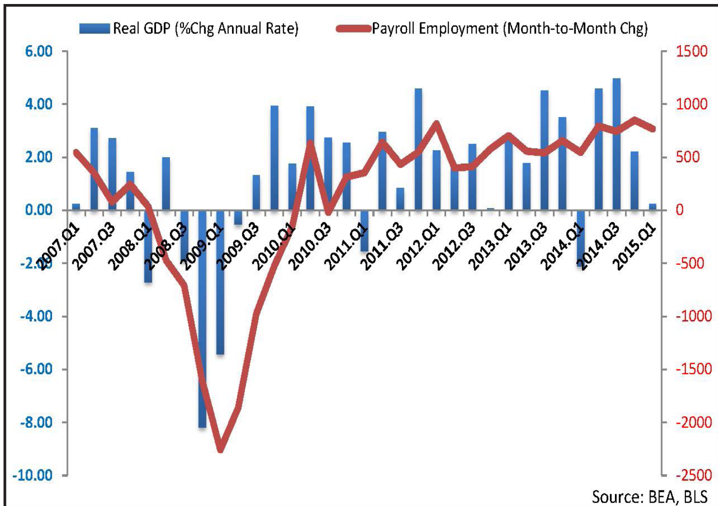
• Tenant concessions were present in 30 percent of SIOR markets.

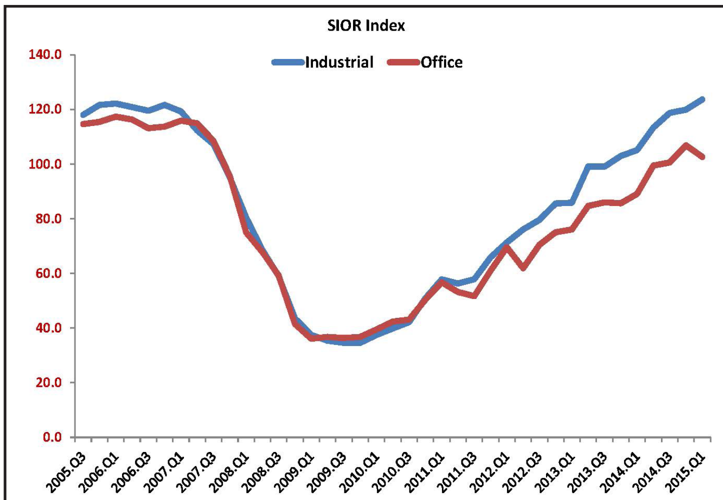
• New construction of office and industrial spaces improved, with almost a third of markets reporting new construction during the quarter.

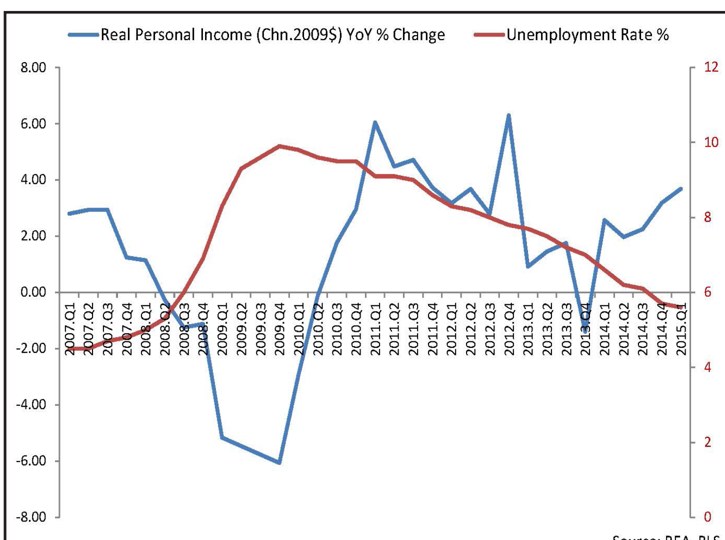
• Development conditions continued shifting in favor of sellers during the period, with 44 percent of SIORs rating it a seller's market.

• Investment prices stayed level, with 50 percent of markets being below construction costs.









THE ECONOMIC OVERVIEW

Although the economic results for the first quarter were disappointing at the national level, SIOR members actually reported good news at the local level in many cases. A total of 52 percent of SIOR members considered their economy to be strong and improving. Therefore, while hardly a "barnburner," the outlook for the rest of 2015 appears to be for positive, although probably slow, growth. Regionally, market performance proved mixed, as the Northeast and West declined and the other two regions gained. Positively, all four main regions recorded index values above 100, signifying market expansion.

• The Midwest retained the highest index value for the second consecutive quarter, at 122.4.

• The South had the second highest index value—122.1.

• The West region took a small step back, sliding from 117 in the last quarter 2014 to 116.6 in the first quarter 2015.

• The Northeast closed the quarter with an index value of 103.5, three points lower than the previous quarter.

Looking ahead at the second quarter of 2015, SIOR members remained upbeat, with 81 percent of respondents pointing to the demand for space growing in the 1-15 percent range. Put differently, the miserable weather of the first quarter is behind us, and the economy appears headed towardsexpansion—although probably well below the 3 percent rate historically experienced.

On a positive note, employment trends provided a hopeful spotlight during the first quarter of 2015, which hopefully will continue for the rest of the year:

• Payroll employment advanced, with the first quarter registering a net 767,000 jobs.

• Adjusted for inflation, average hourly earnings of all employees rose 2.2 percent on a yearly basis, during the first quarter 2015.

• The unemployment rate declined from an average 5.7 percent in the fourth quarter 2014 to 5.6 percent in the first quarter 2015.

• Consumer confidence, as measured by The Conference Board, reached 101.3 in the first quarter of this year, the highest level since the third quarter 2007.

THE ECONOMIC AND COMMERCIAL REAL ESTATE OUTLOOK

NAR's growth forecast for 2015 is for a 2.3 percent increase in real GDP—substantially different from the first quarter decline. Interest rates are projected to remain low, and additional job gains appear likely. Given that the commercial sector moved sideways during the difficult times in the first quarter, it appears likely that we will see a pickup in commercial real estate as the year progresses.

The SIOR index appears likely to report upward progress for the rest of the year given an improving economy and favorable and improving underlying fundamentals for commercial space. Trophy properties appear likely to continue to attract attention in major markets, while secondary and tertiary markets should see some significant upscale potential. Space absorption should exceed new construction coming onto the market, and modest and continued increases in rents are projected. Although conditions can vary from market to market, the overall outlook is positive.

Given an improving economy and a continuation of underlying commercial trends, we should expect continued expansion of the SIOR index.■

Commercial Real Estate Index Methodology

The SIOR Commercial Real Estate Index is constructed as a "diffusion index," a very common and familiar indexing technique for economic measures. Other examples of diffusion indexes include the Index of Leading Economic Indicators, the Consumer Confidence Index, and the Institute of Supply Management's Purchasing Managers' Index. In the SIOR Commercial Real Estate Index, a value of 100 represents a well-balanced market for industrial and office property. Values significantly lower than 100 indicate weak market conditions; values significantly higher than 100 indicate strong market conditions. The theoretical limits of this Index are a low of zero, and a high of 200, though it is unlikely that such limits would be approached as long as the property markets are operating efficiently.

The Index is based on a survey questionnaire with ten topics. The topics covered are (1) recent leasing activity; (2) trends in asking rents; (3) trends in vacancy rates; (4) subleasing conditions; (5) levels of concession packages in leases; (6) development activity; (7) site acquisition activity; (8) investment pricing levels; (9) the impact of the local economy on the property market; and, (10) the effect of the national economy on the property market. Survey respondents are given five choices. For each topic, five choices are provided, corresponding to conditions that are very weak, moderately weak, well-balanced, moderately strong, or very strong.

For each question, answers are tallied and the percentage of responses for each of the five choices is calculated. If survey panelists indicate "very weak" conditions (the "a" choices in the questionnaire), the answer is assigned 0 (zero) points; "moderately weak" ("b" answers) earn 5 points; an indication of "market balance" ("c") receives 10 points; "moderately strong" indications ("d") score 15 points; and "very strong" ("e") responses receive a maximum 20 points. Thus a score of 10 for a given question can be earned if responses are evenly distributed across all five choices, if all responses were "c", or if the answers form a "bell-shaped curve" centered around the "c" choice. The total index value is derived by summing the scores for all ten questions. Index values for each of the two property types are similarly calculated.

The survey was developed by Hugh F. Kelly, CRE, clinical professor at New York University, who worked with SIOR on research projects since 1989.